

RatingsDirect®

Summary:

Kelso, Washington; Water/Sewer

Primary Credit Analyst:

Paul J Dyson, San Francisco (1) 415-371-5079; paul.dyson@standardandpoors.com

Secondary Contact:

Adam Torres, New York (1) 212-438-2481; adam.torres@standardandpoors.com

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Summary:

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Credit Profile

Kelso wtr rev bnds (tax-exempt)

Long Term Rating

AA-/Stable

Affirmed

Rationale

Standard & Poor's Ratings Services affirmed its 'AA-' long-term rating on the city of Kelso, Wash.'s series 2010A water and sewer revenue bonds and series 2010B water and sewer revenue bonds (taxable recovery zone economic development bonds – direct payment). The outlook is stable.

The rating reflects our view of the city's:

- Very strong annual debt service (ADS) coverage at no less than 5x since at least fiscal 2006, including 5.2x in fiscal 2011 and 5.0x in fiscal 2012, and projected at 3.8x in fiscal 2013;
- Very strong system liquidity, with fiscal 2012 cash reserves of \$3.6 million, or approximately 230 days' cash (and projected at \$3.2 million, or 192 days' cash, in fiscal 2013);
- Competitive rates and recent demonstrated willingness and ability to adjust rates; and
- Primarily residential and stable customer base and access to the Cowlitz County economic base as well as jobs in nearby Portland, Ore.

The preceding credit strengths are offset in part by our view of the city's merely adequate incomes, with median household effective buying income (EBI) at just 75% of the national average, and a concentrated customer base, especially with regard to the leading customer, Foster Farms, which represented 44% of water consumption and 52% of sewer usage in 2012.

The net revenues of the combined water and sewer system (the waterworks utility) secure the bonds. We understand that bond proceeds were used to finance system upgrades and expansions. The series 2010B bonds were issued as taxable recovery zone economic development bonds, under the provisions of the American Recovery and Reinvestment Act of 2009, and subsection 54AA(g) of the code applies to the bonds for which the city receives a federal subsidy equal to 45% of interest payable on the bonds. Under the bond ordinance, subsidy payments are treated as revenues but, for purposes of calculating the reserve requirement, are used to offset gross debt service. If the city does not receive the subsidy, it pledges to pay in a timely manner and in full both interest and principal on the bonds. In addition, the city's extremely strong cash reserves of over \$3.2 million provide us with sufficient credit comfort that the district will pay debt service in full in the event of a temporary delay of the subsidy from the U.S. Treasury.

Kelso has a population of 11,925 residents (2010 Census) and is along Highway 5, about 125 miles south of Seattle and 48 miles north of Portland. The city, which serves as the Cowlitz County seat, lies adjacent to the city of Longview. Together, these two cities make up the Kelso/Longview metropolitan area, the major population center of Cowlitz

County. The city has not had much population growth over the past five years, but vacant land exists, as does the potential for new subdivisions and higher density housing. As such, the city projects slight population growth. Growth of the city somewhat depends on water-sewer system expansion, so bond proceeds assisted in that aspect. For 2012, the city's median household EBI was only adequate, in our view, at 75% of the national level. The major employers in the city include Kelso School District, Foster Farms, and Cowlitz County. Kelso's unemployment rate as of August 2013 was 9.5%, versus the state's 6.8% rate and the nation's 7.3% rate.

The waterworks utility consists of the city's water and sewer system. The system's service area encompasses 7.8 square miles, providing water system services to 5,041 customers and sewer system services to 4,406 customers. The leading 10 water customers represented a concentrated 50% of total water consumption as of 2012, with much of the concentration related to Foster Farms, a chicken processor, which represented 44% of consumption on its own. However, in our view, the primarily residential nature of the customer base provides good revenue stability. Foster Farms employs approximately 800 people in its Kelso plant, and this particular facility has been in Kelso since 1998. The city reports that if it lost Foster Farms as a customer, it would need to raise rates 10% to recover.

Average daily water demand is 2.03 million gallons per day (mgd), with peak demand at 3.1 mgd and system capacity of 3.6 mgd. Demand over this capacity level is rare, but can be met with the city's 11 reservoirs of water storage of 5.7 million gallons. The city receives 100% of its water from one city-owned well. The city also has an emergency connection with Longview that it can rely on occasionally, especially when it has to shut down its well for repairs. Water is sourced from below the nearby Cowlitz River, which, according to the city, provides the city with a plentiful supply; the river is near flood levels currently, given wet weather patterns. Water is treated directly at the well head, with a total treatment capacity of 4.2 mgd.

The leading 10 sewer customers represented a concentrated 57% of total water consumption as of 2012, and as with the water system, much of the concentration is related to Foster Farms, which represented 52% of sewer flows on its own. The city reports ample capacity at the Cowlitz Regional Sewer Treatment Plant to handle growth for the next 20 years. Average daily sewer flows in 2012 were 2.94 mgd with sewage treatment capacity of 26 mgd.

Despite a series of annual 7.5% water rate increases that began in January 2008 and that will run through 2014, residential water rates are competitive at approximately \$41 per month for 7,500 gallons of usage. Sewer rates, currently \$54 per month, have been increasing at 3% annually since 2008, and the city has adopted an additional 1% rate increase in 2014.

Financial performance for the system has been very strong over the past five years, highlighted by exceptionally strong debt service coverage (DSC) in light of low outstanding debt and robust liquidity. DSC in audited fiscal 2012 was a very strong 5.0x, and is budgeted at 3.8x for fiscal 2013 and 3.9x for 2014. When including junior-lien debt, all-in DSC was 3.2x in fiscal 2012, and estimated at 2.4x in fiscal 2013. When including a potential borrowing for a \$4.8 million reservoir replacement project in fiscal 2016 (likely via a junior-lien public works trust fund loan), all-in DSC using fiscal 2014 net revenues would be about 1.5x. Management reports no other additional bonding plans through fiscal 2018 and a total capital improvement plan of \$10.7 million, which we view as manageable.

Kelso has not formalized a reserve policy, but strives to keep plenty of cash on hand for emergency purposes. In

general, \$2 million, or approximately six months of operations, is the minimum cash balance target. The city also has an informal internal coverage target of no less than 2x that it has historically exceeded (and projections are consistent with historical experience).

Bond provisions are adequate and include a reserve fund funded at the lowest of 125% of average ADS, 10% of par, or maximum ADS. Bond provisions also include an additional bonds test requiring 1.25x ADS coverage, based on historical net revenues adjusted to account for any approved rate increases, as well as a rate covenant that requires budgeted ADS coverage of at least 1.25x.

Outlook

The stable outlook reflects our expectation that recently implemented and planned rate increases will allow Kelso to maintain very strong coverage and liquidity. The residential nature of the customer base and Kelso's role as the county seat support the credit's stability, in our view, and help to offset credit concerns with regard to top customer concentration. We don't expect to change the rating over the next two years.

Related Criteria And Research

Related Criteria

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 1, 2013

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